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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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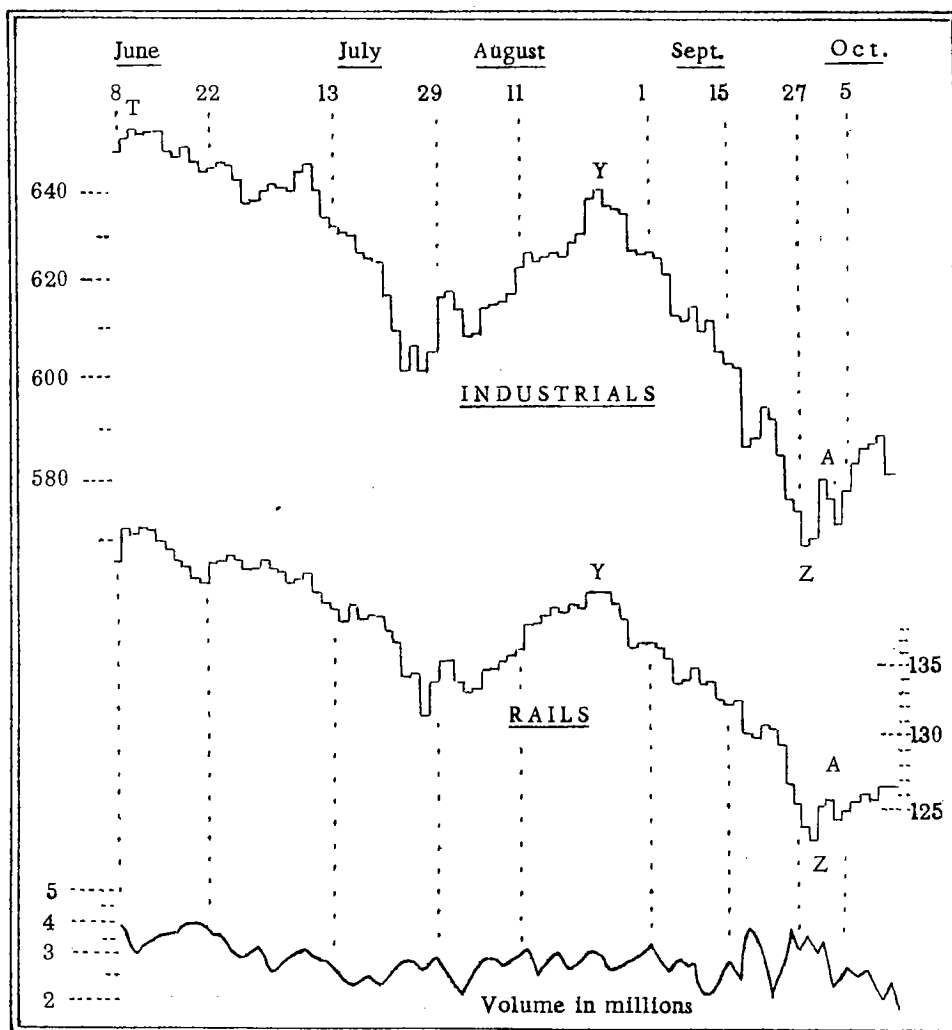
Number 120

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MARKET Over the last month the circulation of these Letters has increased about 15%. Judging from correspondence received, many new subscribers are seeking a degree of forecasting accuracy and certitude which neither this writer nor Dow's Theory can provide. These readers would like a definite, dogmatic prediction for every minor market movement, and although I am puzzled perhaps 60% of the time myself, there are plenty of other services which offer an unhedged forecast for each day of the week (plus a melange of "tips", advice and "inside information"). Through painful personal experience, however, I have come to the opinion that the more dogmatic the expert and the more "infallible" his system, the bigger the "quack".

In Letter 119 I stated that if the A points were bettered the minor trend would be up, in which case, I would cover the better part of my shorts. During the past year comparable upward zig-zags, following extended declines, have presaged fairly good rallies (i.e. May and July, 1960). Although I have stressed the importance of volume in dozens of previous Letters, readers may put me down for a "blooper" for not mentioning volume indications in connection with the A points in Letter 119.

Actually, the penetration of the A points was accomplished in a sluggish market on dull volume, which somewhat diluted the authority of the movement (particularly since the penetration was against the primary trend). Because of this, I covered fewer shorts than I otherwise might have done, and I marked this short covering down as "insurance" against a possible further rise on perhaps belatedly increasing volume. Volume can be deceptive (although less so in primary territory). Often a move will start quietly; then volume will expand as prices work higher. Consequently, there was no single "best" course of action at A. Since many of the shorts recommended have shown substantial profits, however, I felt that insurance against a possible sharp rally or full secondary reaction was warranted. To reiterate, I never fret about "profits that might have been".



but I do try to avoid needless losses.

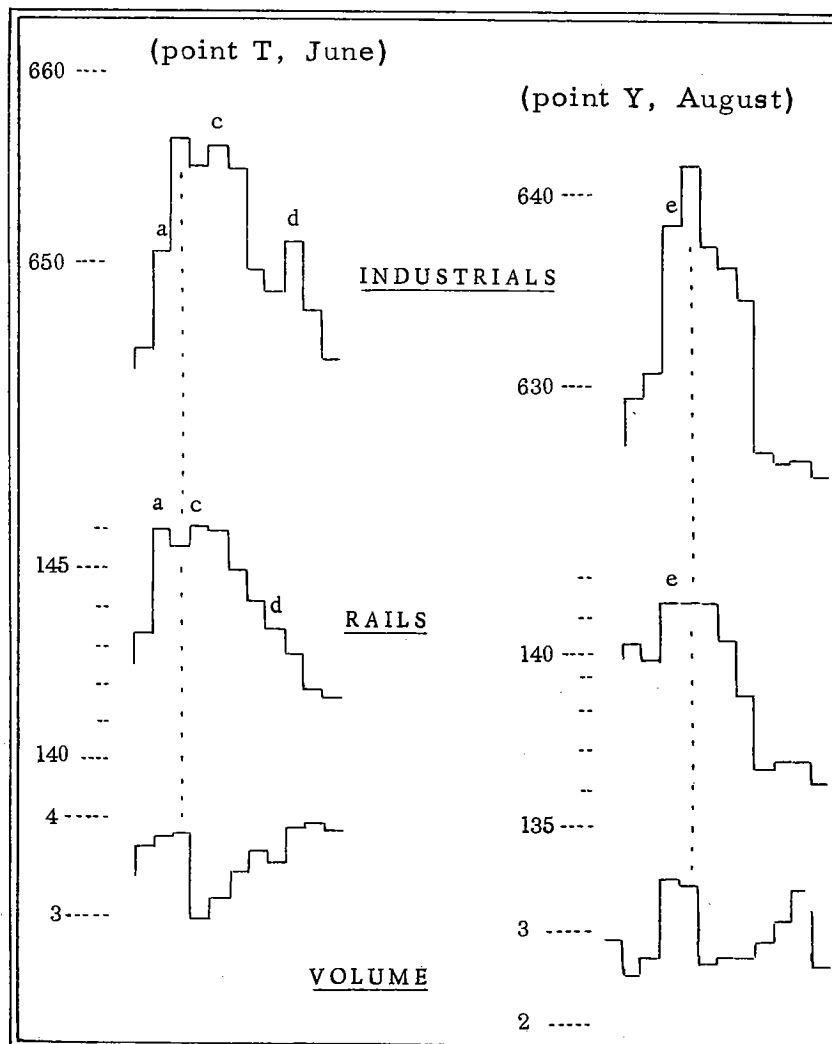
The rally from Z has been unimpressive to date. "Breadth" has been poor, the ratio of new highs to new lows has been unfavorable and volume has grown increasingly dull as the rally progressed (see Letter 119 on "dullness"). The "plus" in the picture is that odd-lot shorting has been picking up over the last week or so. Any or all of these things can change, however, and should another pronounced upward zig-zag develop in both Averages (on increasing volume), it is possible that we could have a secondary reaction correcting 1/3 to 2/3 of the T-Z losses.

When the market appears aimless it is a good policy to give precedence to the prevailing primary trend. In the present case, of course, the primary trend is bearish. I have been buying more six month "puts" in this area, with the stipulation that I will put out shorts if (1) an "in gear" downward movement on increasing volume develops, (2) a further rise turns dull.

TOPS The last Letter included a number of quotes from Hamilton and Rhea concerning bear market rallies and secondary (upward) reactions. This Letter will attempt to carry the subject one step further. Standard procedure for Dow Theorists during bear markets entails putting out shorts at or near rally tops. For this reason our trading problem becomes primarily one of identifying rally peaks (rather than trying to "catch" decline bottoms). Fortunately, it is generally easier during a bear market to spot the end of an upward movement than the beginning. The converse holds true in a bull market.

The accompanying chart shows an enlarged version of the June, 1960, secondary top (point T on the regular chart) and the August rally top (Y on chart). Because a given bear (or bull) market frequently develops its own repetitive characteristics, it is worth examining these two formations in detail. The vertical dotted line on chart indicates the high day for the Industrial Average.

Referring to the June formation, Rails hit a minor peak (a) on increasing volume. The next day Industrials climbed to their high (dotted line), but here Rails diverged (moved in the opposite direction) while volume crept fractionally higher. On the third day (c) Rails established their peak prices, but Industrials would not confirm by bettering their high of two days before. Volume at c also dropped drastically. Thus at point c we had three danger signals coming after a sustained rally against the primary trend: (1) divergence on the peak Industrial day, (2) Industrials refusing to confirm the Rail high at c, (3) volume dropping sharply at c as Industrials approached their high. Following these danger signals both Averages fell away as volume



expanded. A verification of the weak situation came at point d when Industrials rallied and Rails diverged again.

The August top provided equally convincing signs of danger. At point e volume expanded to 3.5 million shares, and both Averages moved higher. On the peak day (dotted line) Industrials rose a few points, but Rails would not budge, and volume ran almost as high as the preceding day. This high volume accompanied by a minor advance in one Average and no movement in the other suggested "churning" (distribution under the guise of excited activity). On the day following the peak, volume dropped, Industrials retreated, but Rails again held within their little "line". When, on the next day, both Averages got "in gear" on the downside the odds obviously favored lower prices.

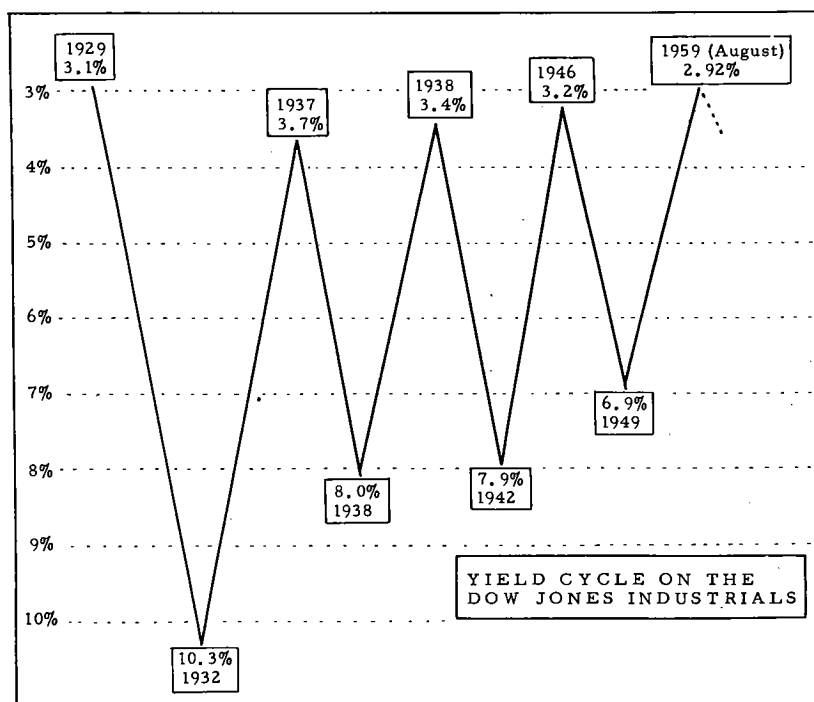
Thus, both the June and the August tops came subsequent to sustained rallies in a bear market, and in both cases the danger signals were obvious enough so that shorts might have been put out reasonably near the highs. Reviewing the two situations, the danger signals were as follows: (1) "churning", (2) divergence, (3) non-confirmation, (4) volume dropping drastically as a preceding high was again approached.

WATCH VALUES The "BUSINESS OUTLOOK" column which appears on the front page of the Journal of Commerce (October 10) begins: " 'Yes, we are now in a business recession. But it will be mild and comparatively short, with improvement beginning about the middle of next year'. This, in capsule form, summarizes the public pronouncements of a number of businessmen and economists during the past week or two. "

While the majority opinion may be correct in that this will indeed be a mild recession both in business and in stock prices, from a Dow Theory standpoint there are many things to ponder. Long-term market appraisals must take into account values, price movements, phase, volume, speculative interest, crowd participation, etc. Some months ago I wrote a few paragraphs concerning the question of values as measured by return on investment (yield). The accompanying chart shows the broad swings of values in terms of the average yield on the thirty D-J Industrial stocks. As early as 1901, Dow noted: "When a stock sells at a price which returns only about 3 1/2% on the investment, it is obviously dear. . ." Records compiled since the turn of the century attest to the correctness of Dow's early observations, and the chart shows eight of the broad yield swings since 1929. It is apparent from the chart that investors tend to accumulate stocks when they are fundamental values (or when yields are in the 6-9% area). It is equally obvious that when stocks become over-valued (yields in the 3-3 1/2% area) informed investors tend to distribute them.

For five weeks in late July and August, 1959, the average yeild on the D-J Industrial stocks dropped below 3%. This marked the lowest yield area ever to appear at a bull market top. By last week, according to Barron's, Industrial yields on the Dow had risen to 3.72%. But unless we ignore everything we have learned about the historic movements of values, the present market is still in the yield area which suggests informed distribution, not accumulation. It should take readers only a minute to figure a possible bear market bottom range for the D-J Industrials, using a relatively favorable basis of perhaps 6% average yield (even assuming that there will be no dividend cuts between here and the eventual bottom).

MONEY For many years sophisticated investors have had a relatively easy time of it. As soon as the stock market showed signs of an impending reversal, they merely switched into bonds and waited for the "Fed" to "make money easy". It was all so simple -- the Fed lowered the discount rate, bonds went up as stocks went down; then after a pause stocks started up again (in response to further inflationary pressures and credit expansion.)



I last mentioned the long-term bear market in bonds in Letter 117. Following that discussion I received many dissenting letters from readers (mostly bankers) who informed me that money was going to get very "cheap" and that consequently, bonds had to go up. I enclose a clipping from last week's New York Times, however, which suggests that quite the opposite has been occurring.

The chart of the yields on the sensitive 91 day Treasury bills (last seen in Letter 117) is shown on this page. Note the double "testing" of the 2.15% bottom in July and August, the advance in yields to 2.65% in mid-September and the "re-testing" of the lower area (the last retreat held at 2.30% in September). In October a fresh yield advance was underway, and this week the Treasury paid the highest price (2.69% average yield) for a new bill issue since June 7.

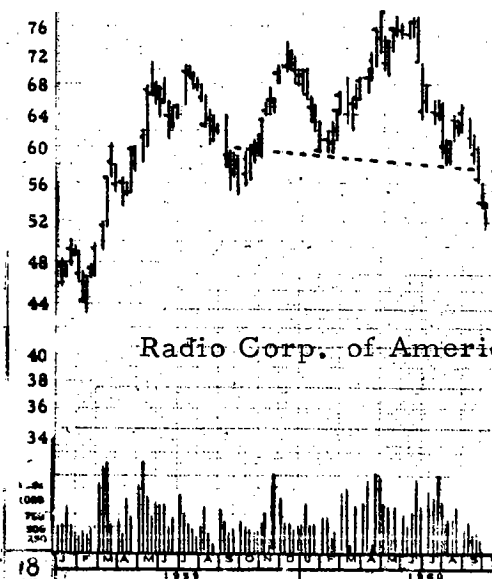
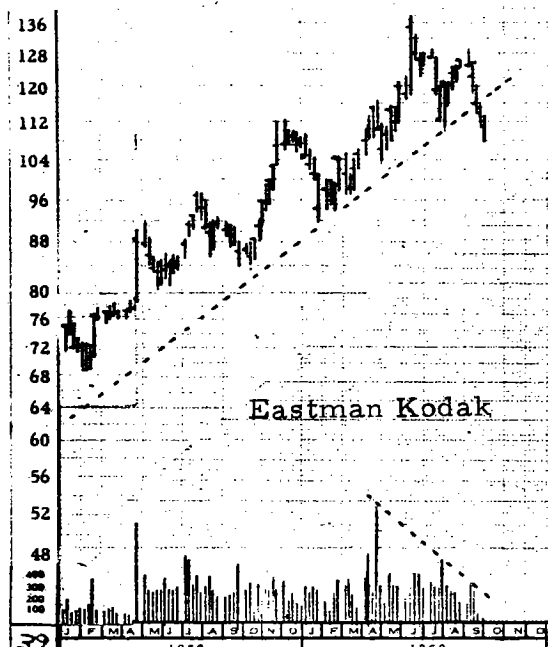
There are a variety of opinions regarding the present heavy performance of the bond market. One technical depressant is that many large speculators have loaded up with bonds in the hopes of another discount cut. But the gold outflow seems to have ruled this out at present. The continual pile-up of new financing has also acted as a brake; no sooner is one bond issue "placed" when three more arrive. Debt is still expanding in many areas of the economy with no sign of a let-up. Thus the Wall Street Journal announced last week: "NOVEMBER BALLOT TO INCLUDE RECORD 3.3 BILLION BONDS. Proposed Tax-Exempt Issues Surpass '56 High, More Than '59 Total." It is not an encouraging picture for bond holders, and for this reason I continue to suggest that cash be held in short-term Treasury bills.

STOCKS An amazing number of subscribers have written to tell me that they shorted Motorola (Letter 118). I only wish that all my recommendations worked as well. The stock has dropped so fast that perhaps half of the short commitments in MOT should now be covered.

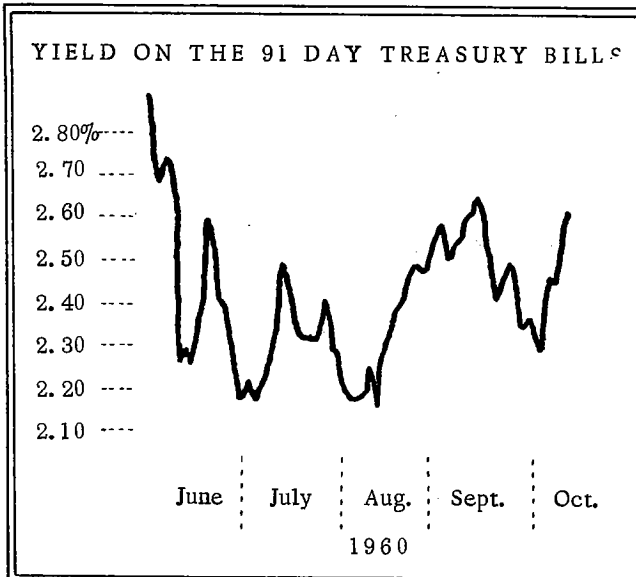
Below are weekly charts of Eastman Kodak and R. C. A. EK has broken a two year major trend line and a base at 110; it can be shorted at the market. R. C. A. cracked at 70, again at 58 and could go much lower. Try to get shorts off as near to 54-6 as possible.

A SAD NOTE The writer is going to the hospital on October 17 for a hernia operation. A friend remarked that the hernia may have resulted from "trying to hold up the market". At any rate, there will probably be a ten day to two week interval between this Letter and Letter 121. If absolutely necessary, I will send an abbreviated Letter beforehand. The foregoing also means that I will not be able to handle personal correspondence for a few weeks.

(Written -Thursday
October 13 - 12 noon)



Charts courtesy of Traders Research, Inc.
P. O. Box 6185, Lambert
Lambert Airport, Mo.



**YIELD ABOVE 4%
BACK IN U. S. LIST**

Return on 3 1/2s of '98 F.
at Such a High Level Since
Early in the Summer

By **PAUL HEFFERNAN**

High-grade bond prices de-
clined all along the line yester-
day's trading session was pro-